Testimony

of

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Concerning

The Securities Fraud Deterrence and Investor Restitution Act, H.R. 2179

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Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee:

On behalf of the Securities and Exchange Commission, I am pleased to be here to testify before you. In inviting me here today you have asked that I discuss the Securities Fraud Deterrence and Investor Restitution Act, H.R. 2179 (the "Bill"), which recently was introduced by Chairmen Oxley and Baker, as well as other members of the Subcommittee.

As you know, I testified before the Subcommittee last February concerning the findings and legislative recommendations contained in a number of reports the Commission submitted to Congress pursuant to the Sarbanes-Oxley Act. H.R. 2179

incorporates a number of the proposals from the Commission's reports, which, if adopted, would strengthen the Commission's enforcement capabilities and assist defrauded investors. These provisions would greatly enhance the effectiveness of the Commission's enforcement investigations, and significantly improve the Commission's ability to prosecute wrongdoers, collect money from them, and return it to injured investors. Accordingly, I commend Chairmen Oxley and Baker, and the other sponsors of this legislation, for their initiative and commitment in introducing this very useful and potentially far-reaching bill.

I. Removing state law barriers to Commission debt collection

Section 2 of the Bill would improve the Commission's collection efforts by eliminating state laws that enable defendants to shield their assets from Commission judgments or orders in their homesteads. Specifically, it would authorize the Commission to force the sale of any property owned by a person against whom it obtained a judgment or order based on fraudulent conduct in order to satisfy the judgment or order, notwithstanding any state law that protects homestead property.

The homestead exemption arises in Commission litigation when a defendant fails to pay disgorgement ordered, and the Commission files an action in federal district court asking the court to hold the defendant in contempt of court for that failure to pay. In contempt actions, defendants often assert that they cannot pay some or all of the owed disgorgement because they lack sufficient assets. As a result, during the contempt

proceeding, the court must determine which of a defendant's assets are available to pay disgorgement. In the case of exempted assets, such as a homestead, the court has considerable discretion in determining whether or not that exempted asset must be used to pay disgorgement.

The Commission encounters cases where securities law violators can rely on state law homestead exemptions and other protections to shield their assets from collection. All states have statutes that exempt certain property from collection by creditors, including the Commission. Some defendants use these exemptions to shelter their assets from collection. For example, in certain states, defendants can shelter millions of dollars in their primary residences — using the "homestead" exemption — that might otherwise be available for collection by the Commission. Currently, when trying to collect disgorgement, the Commission's staff, at best, must engage in protracted litigation to avoid state law exemptions and at worst may be precluded from reaching assets that should be returned to the victims of securities fraud.

Two examples of difficulties encountered by the Commission are illustrative of the effects of the homestead exemption:

- The case of SEC v. American Automation, Inc., et al. involved the fraudulent sale of $4.2 million in unregistered stock to at least 450 investors in several states by defendants Kendyll R. Horton, Hazel A. Horton, Merle B. Gross, and Jayne Roose. The Commission obtained summary judgment against defendant Hazel Horton, and on May 31, 2002, the district court ordered

Horton to pay $4.58 million in disgorgement. When Horton failed to pay, the Commission filed an action in contempt against her. Despite the favorable precedent in this jurisdiction (the Northern District of Texas), the court did not allow the Commission to use Horton's homestead to satisfy the judgment. The court allowed Horton to remain in her homestead (until she voluntarily moves or dies) even though she had violated an asset freeze by mortgaging the homestead and had used investor funds to improve the homestead. Hazel Horton remains in her home today.

- In SEC v. Great White Marine & Recreation, Inc., et al., the Commission charged defendant Alvis Colin Smith, Jr. with orchestrating a $10 million pump-and-dump stock scheme. In 1999, the Commission filed suit against Smith and his related corporation, Great White Marine and Recreation, Inc. The Commission alleged, among other things, that Great White and Smith had offered and sold unregistered shares of Great White's stock using false statements in press releases, promotional brochures, Internet website postings, and in a Commission filing. On June 19, 2001, the district court entered a final judgment against Smith, requiring him to disgorge $3 million, three lakeside lots, several vehicles, and various other assets. Although Smith did disgorge some of the assets, he failed to deliver others. The Commission moved for contempt, seeking his homestead. The Commission presented evidence tracing funds from the fraud directly to repayment of the mortgage on the homestead. On October 12, 2001, the district court found Smith to be

in contempt of court and ordered him incarcerated until he disgorged several vehicles and his interest in the residence. In addition, the court strongly expressed the view that Smith's wife (who was not named in the Commission's action) should be allowed to keep at least her interest in the homestead. Accordingly, a court-appointed agent settled by allowing Smith's wife to keep approximately one-half of the equity in the homestead. Smith subsequently pled guilty on related criminal charges and is again incarcerated.

In sum, by overriding state homestead laws, Section 2 of H.R.2179 would make more assets available for recovery by the Commission and for return to defrauded investors. In addition, Section 2 should increase the deterrent value of Commission enforcement actions against wrongdoers by depriving them of more assets.

II. Civil enforcement provisions

Section 3 of the Bill contains several important provisions to strengthen the Commission's enforcement program.

A. Providing penalties in administrative cease-and-desist proceedings

Section 3(a) would enhance the effectiveness of the Commission's cease-and-desist proceedings by authorizing the Commission to impose money penalties in these proceedings. Currently, the Commission has two primary means of seeking civil

penalties: in administrative proceedings against entities and persons directly regulated by the Commission, such as broker-dealers or investment advisers; and in federal court actions against any entity or person. The Commission also has authority to seek remedies other than civil penalties against any entity or person in an administrative proceeding.

The result of this patchwork is that in some circumstances the Commission must file two separate actions against the same entity or individual to obtain the appropriate array of relief. For example, if the Commission finds cause to order a company or a corporate officer to cease-and-desist from violating the securities laws but also seeks to impose a civil money penalty, two separate actions concerning the same facts must be filed. Similarly, if the Commission wished to employ its new authority to seek an officer and director bar administratively, and also wished to seek a money penalty from the corporate officer, it would have to file two separate actions. Moreover, under current law, if the Commission charges a respondent with "causing" another party's violation of the securities laws (a concept similar to aiding and abetting) in an administrative cease-and-desist proceeding, the Commission can impose a monetary penalty only in very limited circumstances.[1]

By granting the Commission additional authority to seek penalties in cease-and-desist proceedings, Section 3(a) would eliminate inefficiency, give the Commission added flexibility to proceed administratively, and strengthen the Commission's ability to

[1] The Commission may in limited circumstances seek a penalty in a cease-and-desist proceeding against anyone who was a cause of a violation of certain provisions of Section 10A of the Securities Exchange Act of 1934.

hold those who assist in violating the securities laws financially accountable for their actions. This provision also would provide appropriate due process protections for subjects of administrative penalty proceedings by making imposition of a civil penalty in an administrative cease-and-desist proceeding appealable to a federal court of appeals.[2]

B. Increasing penalty amounts in civil actions and certain administrative proceedings

Section 3(b) would significantly increase the amount of penalties that the Commission may seek for violations of the federal securities laws in many types of actions. Currently, in non-insider trading cases, the Commission may obtain penalties for each violation up to the greater of (1) $6,500 to $600,000 or (2) the defendant's gross amount of pecuniary gain as a result of the violation.[3] The size of the penalty depends on the nature of the wrongful conduct, whether the penalty is sought against a natural person or entity, and whether the conduct involved substantial loss or risk of substantial loss by investors. As conduct becomes more egregious, the maximum penalty amount increases. Section 3(b) would increase the penalty amounts the Commission may seek in civil actions and certain administrative proceedings. Under the proposed legislation, penalties could range in size from $10,000 to $2 million per violation.

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[2] As noted, Congress recently expanded the Commission's authority to obtain another type of relief in an administrative context in Section 1105 of the Sarbanes-Oxley Act, which granted the Commission authority to impose officer and director bars in administrative cease-and-desist proceedings.

[3] *See, e.g.*, Section 21(d)(3)(B) of the Exchange Act.

Increasing the size of penalties is an important step in achieving the desired deterrent effect under the securities laws, especially in light of the exponential growth of our capital markets during the last ten years. In addition, by using the Fair Fund provision contained in Section 308(a) of the Sarbanes-Oxley Act, the Commission may more fully compensate injured investors if larger penalties are paid.

C. **Improving access to bank and other financial institution records**

Section 3(c) would eliminate the existing requirement that customers of banks and other financial institutions be notified of Commission subpoenas seeking access to their financial records, and so would enhance the Commission's ability to obtain and use account information, to quickly and effectively trace and identify funds, and to thereby uncover relationships among suspected wrongdoers. Specifically, under the provision, banks would be authorized to provide information about customers' accounts on an expedited basis, and without notifying their customers in certain circumstances.

The Commission requests bank records when it has reason to suspect that the passage of money among persons or entities may relate to violations of the securities laws. Quickly unraveling such relationships, and identifying any assets obtained or transferred in connection with unlawful activity, are critical to the Commission's ability to obtain orders freezing assets. Delay in obtaining these records almost invariably benefits the wrongdoers and may deprive investors of any meaningful opportunity for redress.

Current law generally requires that, prior to obtaining bank records, the Commission provide notice to the account holder and wait ten to fourteen days to permit the customer to contest the Commission's request. If the customer does file a challenge, the federal courts will frequently take four to six months to resolve the challenge, even though the Commission invariably has met the standard that the requested records be relevant to a legitimate law enforcement inquiry.[4]

During the required notice period, a person may hide assets, destroy evidence, or even flee the jurisdiction. While current law permits the Commission to seek court authorization to obtain bank records without first notifying the customer, this procedure may require the expenditure of significant staff resources and result in substantial delay — which also compromises important enforcement objectives.

Section 3(c) would address both the notice and delay problems by allowing the Commission the discretion – though only in those cases in which it already has authorized a formal investigation – to obtain bank records without notice to the customer. This change would enable the Commission to more quickly uncover securities law violations and more effectively enforce the securities laws by obtaining appropriate asset freezes and preserving assets for the benefit of defrauded investors.

[4] The Commission responds to challenges by showing that its investigative subpoenas are issued in connection with a formal investigation.

III. Removing barriers to the production of privileged information

Section 4 of H.R. 2179 would allow a person to provide privileged information to the Commission without waiving that privilege as to other persons. If adopted, this provision would help the Commission gather evidence in a more efficient manner by eliminating a strong disincentive to parties under investigation to voluntarily produce to the Commission important information.[5]

Voluntary production of information that is protected by the attorney-client privilege, other privileges, or the work product doctrine greatly enhances the Commission's investigative efforts, and in some cases makes them more efficient. Particularly in financial fraud investigations, the Commission may learn of the existence of an internal inquiry conducted by an issuer's attorneys. The issuer may be willing to share such information with the Commission's staff if the issuer could otherwise maintain the privileged and confidential nature of the information. Currently, a person who produces privileged or otherwise protected material to the Commission runs a risk that a third party, such as an adversary in private litigation, could obtain that information by successfully arguing that the production to the Commission constituted a waiver of the privilege or protection.[6]

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[5] Of course, the Commission must always be free to disclose in an enforcement proceeding the documents produced to it (even pursuant to a confidentiality agreement) if the Commission determines that it is necessary in furtherance of the discharge of its duties and responsibilities. This would be true even if such use (as distinct from the mere production of the documents) resulted in a waiver of the privilege.

[6] *See., e.g., In re Columbia/HCA Healthcare Corporation Billing Practices Litigation*, 293 F.3d 289 (6th Cir. 2002), *petition for cert. filed*, 71 U.S.L.W. 3429 (Dec. 9, 2002) (finding waiver of privilege where company had previously produced documents to government agencies under confidentiality agreement). The Commission has appeared as amicus curiae in a number of state court cases to urge that a defendant

This situation creates a substantial disincentive for anyone who might otherwise consider providing protected information.

Section 4 would help the Commission's enforcement staff gather information in a more efficient manner. More expeditious investigations could lead to more prompt enforcement actions, with a greater likelihood of recovery of assets to return to investors.

IV. Improving access to grand jury information

Section 5 of the Bill would enhance the Commission's access to grand jury information. Specifically, it would authorize the Department of Justice, subject to judicial approval in each case, to share grand jury information with the Commission staff in more circumstances and at an earlier stage than is currently permissible. The judicial approval would be based on a finding of the Commission's "substantial need" to be informed. Federal and state financial institution regulators already have the kind of access to grand jury information that Section 5 would provide to the Commission.[7]

Under existing criminal procedure law applicable to the Commission, in most cases the Commission's staff will not receive access to grand jury information, and therefore the staff must conduct a separate, duplicative investigation to obtain the same information already in the hands of federal criminal authorities. The "grand jury secrecy

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who produced such material to the Commission subject to a confidentiality agreement has not waived the protection for attorney work product.

[7] *See* 18 U.S.C. 3322.

rule" results in an inefficient use of government resources, and places additional burdens on private persons who must provide essentially the same documents and testimony in multiple investigations.

Enacting Section 5 would make it possible for the Commission to efficiently receive timely information required to complete investigations and prosecutions, and avoid unnecessary duplication of government efforts.

V. Providing for nationwide service of civil trial subpoenas

Section 6 of the Bill would authorize the Commission to make nationwide service of trial subpoenas available in the Commission's civil actions filed in federal district court.

Under current law, the Commission may issue trial subpoenas in federal court actions only within the judicial district where the trial takes place or within a "100-mile bulge" from the courthouse. When witnesses are located outside of the district court's subpoena range and fail to volunteer to appear at trial, the staff must take the witnesses' depositions, and then use those depositions at trial. Such deposition testimony is more expensive and less effective than live testimony.

The Commission currently has authority for nationwide service in administrative proceedings. The Commission's favorable experience in the administrative forum

supports extending those provisions to civil actions filed in federal district courts. Moreover, other federal agencies with comparable missions have long had such nationwide service authority.[8]

Granting the Commission authority to serve trial subpoenas nationwide would provide substantial advantages. The Commission would save significantly on the costs of creating and presenting videotaped deposition testimony, on travel costs, and on staff time due to the elimination of unnecessary depositions. It would also provide the benefit of more frequent live witness testimony before trial courts in Commission cases.

VI. Authorizing the Commission to contract with private counsel to collect debt

Section 7 of the Bill expressly authorizes the Commission to retain private legal counsel to collect debts owed as a result of Commission judgments or orders, and to negotiate the appropriate fee to pay such private legal counsel.

This is a particularly important aspect of H.R. 2179. Any successful collection program must have a strong litigation component; current law, however, allows the

[8] Congress has enacted more than ten statutes that authorize the issuance of trial subpoenas by district courts for witnesses beyond the limitations found in Federal Rule of Civil Procedure 45 (which applies to the SEC currently). The exceptions include: (1) the Clayton Antitrust Act, 15 USCA 23; (2) RICO, 18 USCA 1965(C); (3) the Bank Holding Company Act, 12 USCA 1974; (4) the Voting Rights Act of 1965, 42 USCA 1973I(d); (5) the Federal Food, Drug and Cosmetic Act, 21 USCA 337; (6) the Federal Election Campaign Act, 2 USCA 437g(a)(7); (7) the Ethics in Government Act, 28 USCA 1365(b); (8) the Clean Air Act, 42 USCA 7523(b); (9) the Egg and the Poultry Products Inspection Acts, 21 USCA 467c and 1050; (10) the Federal Hazardous Substance Labeling Act, 15 USCA 1268; (11) the Public Utility Regulatory Policies Act, 15 USCA 717z(g)(2)(B).

Commission to contract for non-litigation collection services only. This is in contrast to the Department of Justice, which does have authority to hire private counsel to collect judgments. Thus, collection litigation must be carried out by SEC staff, who are diverted from investigating and stopping other violations of the federal securities laws. Moreover, collection of disgorgement judgments requires knowledge of a variety of state execution procedures. Requiring Commission enforcement staff to become proficient in the law and procedures of multiple jurisdictions further diverts staff time and attention from their principal mission of enforcing the federal securities laws.

Section 7 would enable private attorneys to conduct litigation for the Commission under the Federal Debt Collection Procedures Act ("FDCPA") to collect judgments. In addition, private attorneys hired by the Commission would conduct litigation tailored to the collection of disgorgement, including filing contempt proceedings and using state law procedures required to execute on disgorgement judgments.

If adopted, Section 7 would conserve staff resources for major mission functions — investigating and stopping securities violations – while potentially increasing amounts available to recompense injured investors. Further, local attorneys with expertise in the complexities of state collection laws should provide quicker and more efficient returns.

VII. Amendments to the Fair Fund provision

Section 8 of H.R. 2179 contains three substantive amendments to the Fair Fund provision, Section 308(a) of the Sarbanes-Oxley Act.

A. Broadening Fair Fund's application

Section 8(a) would amend the Fair Fund provision by allowing the Commission to use *any* penalties paid as a result of Commission actions to compensate investors injured by defendants in such actions.

The Fair Fund provision, Section 308(a) of the Sarbanes-Oxley Act, was a groundbreaking measure to help the Commission return more funds to defrauded investors. The Fair Fund provision changed the law to permit penalty amounts collected to be added to disgorgement funds in certain circumstances. However, as enacted, the provision only permits the Commission to add penalty amounts to disgorgement funds when a penalty is collected from the *same defendant* that has been ordered to pay disgorgement. There are cases, however, where some defendants may not be ordered to pay disgorgement and it would be beneficial if the Commission could distribute penalties collected from these defendants (as well as from defendants who are paying disgorgement) to harmed investors in that case. Indeed, in some cases, the Commission may not obtain disgorgement from any defendant, but may obtain civil money penalties. In such cases, it might nevertheless be feasible to create a distribution fund for the benefit

of victims in that case. Section 8(a) would make it possible to return these additional funds to investors.

B. **State judgments or orders**

Section 8(c) provides that if a state establishes, by agreement or judgment, a requirement for brokers or dealers that is different from the requirements of the federal securities laws, then penalties or disgorgement paid as a result of the agreement or judgment shall be remitted to the Commission for distribution to injured investors pursuant to the Fair Fund provision.

Congress long ago created a dual securities regulatory system in which both federal and state agencies serve specific, valuable functions in protecting investors. At the same time, there is little question that the imperative to achieve consistent regulation of the U.S. securities markets dictates the need for a single, dominant, national regulator. This is not meant to suggest, however, that the states should be relegated to the backseat of our regulatory system. State securities agencies have played — and should continue to play — a significant role in making our securities markets the most respected and trusted in the world. The more resources — federal and state — we can bring to the cause of maintaining this status, the better off investors are.

During the past year, the overlapping responsibilities of federal and state securities agencies have been vividly illustrated by the joint investigations of research

analyst practices undertaken by the Commission, the self-regulatory organizations, and the states. The Commission believes it is important to return funds collected through enforcement actions to harmed investors whenever possible. Accordingly, the Commission and other federal regulators determined to use their portion of the monies obtained in the global research analyst settlement to recompense investors. We invited the states participating in the global settlement to contribute their portions of the settlement payments to the federal distribution fund as well. Thus far, one state – the State of Missouri – has responded affirmatively to our invitation and has expressed an interest in working with us to distribute disgorgement/penalty amounts to investors.

The policy question of whether Section 8(c) strikes the appropriate balance between state and federal securities enforcement power is appropriately Congress's and not the SEC's to resolve. Moreover it is one that may require further study. The Sarbanes-Oxley Act Fair Fund provision has been in effect for less than one year, and our experience in distributing funds from the global settlement and other cases pursuant to the Fair Fund provision, may yield important lessons for this Committee. In addition, in assessing Section 8(c), it is important to determine how it would affect incentives to, and fiscal constraints on, states' ability to pursue securities-related misconduct aggressively and vigorously. Should you decide that Section 8(c) does strike this balance, there are also some technical drafting issues that we would be pleased to discuss.

C. **Investor education and financial literacy**

In situations where it is not feasible to distribute all disgorgement funds or Fair Funds to victims of a violation, Section 8(d) of H.R. 2179 provides that the Commission may use undistributed amounts in such funds to educate investors. Specifically, it authorizes the Commission to seek or issue an order directing that such undistributed monies be used for investor education programs to be administered by an established not-for-profit or governmental organization.

Financial literacy is a crucial foundation for participation in our capital markets. People need to be able to "read, write and speak" basic financial concepts in order to make informed decisions about investments. In addition, the Commission's enforcement program benefits from financial literacy because an educated investor is the first line of defense against fraud. A financially literate investor can ask better questions about a potential investment and is better able to discern investment claims that are just "too good to be true." Thus, investor education is an important tool to help prevent securities fraud.

VIII. Conclusion

The Commission supports Congressional action to improve the Commission's enforcement capabilities. Certain elements of the proposed Securities Fraud Deterrence and Investor Restitution Act, in particular, would greatly assist the Commission in fulfilling its enforcement mission to prevent, detect and prosecute securities law

violations, and to provide recompense to injured investors. We look forward to working with this Subcommittee in the future to further these important goals.